

Taming the wild card in the deck

Emerging markets offer attractive investment opportunities, but opportunity comes with risk,

as Lisa Pennell reports

Emerging markets could well be described as the wild card in the deck of international investment options. Including the regions of South America, Latin America, Eastern Europe and much of South East Asia (excluding Japan), the term is used to describe developing countries that are industrialising at a fast pace.

Emerging markets (EMs) are exciting to investors, offering high potential gains over the medium to long term. Few EMs offer significantly higher yields than developed markets - it's all about the potential for capital growth. The flipside to the possibility of superior returns is that EMs are volatile and carry high risks for investors, particularly in the short term.

Typically, EM economies feature relatively low levels of income per capita, but have the potential to significantly increase the level over time. To qualify as an EM from an investment perspective, they must also have a local stock-market that is available to foreigners for investment. The biggest and fastest growing countries in the EM category that have attracted the bulk of investor attention over recent years are Brazil, Russia, India and China - also known as the BRIC economies. Along with these, there are opportunities in less prominent but also promising countries, including Thailand, Hong Kong, Taiwan, Malaysia and Korea.

Between 2003 and 2007, EM funds outpaced most other types of managed funds with a healthy rate of growth; but the unfolding global financial crisis (GFC) served to highlight intrinsic

'Volatility is exactly what makes these regions attractive to long-term investors'

risks and volatility. EM share prices were hit harder than those in developed markets, with the MSCI Emerging Markets Index plummeting by more than 40 per cent in \$A terms in 2008. This drop was significantly more than falls in the MSCI World index and the S&P/ASX200 Accumulation Index of Australian shares.

But rather than serving as a warning to avoid EMs, the trend of volatility is exactly what makes these regions attractive to long-term investors with an appetite for risk. Post GFC, EMs recovered earlier and more strongly than developed markets, mainly due to their match fitness when the crisis began. Most of the EM countries had built up reserves pre-GFC that they were quickly able to draw on; and they also had low levels of debt - both of which insulated those economies from the more serious effects of the crisis suffered in many developed markets.

Nader Naeimi, senior investment strategist for AMP Capital, says EMs had the will and

resources to provide stimulus to their economies without incurring the levels of sovereign debt that the US, UK and Europe have.

"Many EMs still have significant resources, are still in surplus and are able to continue to stimulate their economies. It's a global rebalancing - the emerging world has all the dynamics of growth with a good combination of external and domestic demand," Naeimi says.

"The exception is Eastern Europe, which is still quite vulnerable."

And the official statistics support this. In the most recent World Economic Outlook released in July 2010, the International Monetary Fund (IMF) showed that while advanced economies grew by just 0.5 per cent in 2008 and contracted by 3.2 per cent in 2009, emerging/developing economies grew by 6.1 per cent and 2.5 per cent, respectively, during the same periods. Going forward, the IMF has predicted that growth in emerging economies will continue to far outpace that of developed economies in the near term. In 2010, advanced economies are projected to grow by 2.6 per cent, dropping slightly to 2.4 per cent in 2011, while emerging and developing economies are slated to grow by 6.8 per cent this year and 6.4 per cent in 2011.

These figures hide quite large variations within each of the categories. For example, while the UK is projected to grow by just 1.2 per cent in 2010 and 2.1 per cent in 2011, China is projected to grow by 10.5 per cent and 9.6 per cent over the same periods. Other high EM performers include India at 9.4 per cent in 2010 and 8.4

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per cent in 2011; and Brazil at 7.1 per cent and 4.2 per cent, respectively.

Outside of short-term projections of growth, David Urquhart, portfolio manager of the Fidelity Asia Fund, points to other compelling factors which suggest further outperformance in the future for EMs. One is the sheer size of the opportunity - around two-thirds of the world's population live in EMs. He says 20 years ago, 70 per cent of the world's growth was generated by developed economies and nearly a third of this by the US alone. Today, EMs now account for almost three-quarters of global economic growth.

"A comparison of the developed and emerging worlds shows clearly where the potential growth is to be found. The size of EM economies per head of population is still a fraction of the equivalent measure in places like Japan, Germany and the UK. In Japan for example, GDP per capita stands at \$44,000, while in China it is still less than \$4450," Urquhart says.

"In 2000, developing countries were home to 56 per cent of the global middle class, but by 2030 that figure is expected to reach 93 per cent. An increasing middle class means an increase in the associated demand for goods and services, as well as increasing political stability.

"Additionally, credit ratings have been slashed among some Southern European countries of late, while at the same time these rating houses have been boosting outlooks for Asian countries, including India, Indonesia, South Korea and the Philippines."

Urquhart points out that another positive side effect of the GFC for EMs, particularly in Asia, was the opportunity to expand market share in developed markets, due to cost-consciousness fuelled by the troubled times.

"During the crisis, brands like Acer, Hyundai, Samsung and LG became more attractive to consumers who were looking for good value for money. So even though total consumption



Pat Farrelly

declined, the market share of some Asian brands was increasing, resulting in a stable or even growing performance for those businesses."

Urquhart adds that local EM brands often have more success expanding in their own local markets than in developed markets, so investing directly in EMs can be more effective than via multinationals with EM exposure.

"EMs are generally looking for a lower price point for products. It's much easier for a local company in that market to provide that product, then add features to suit developed markets, than the other way around.

"Also, those local businesses will not have the drag common to businesses which have the bulk of their enterprise based in the slower growing, developed markets. EM businesses have the full

'The key aspects to be wary of include sector biases and the effect of government policy'

advantage of fast growth in all aspects of their operation, leading to faster growth overall.

"The more evolved a business or the marketplace is, the harder it is to grow."

While there is a clear potential upside to investing in EMs, the risks should not be underestimated. Some of the key aspects to be wary of include sector biases, the effect of government policy, and general volatility.

Emerging economies usually rely on a narrow range of sectors - especially agriculture and commodities - to fuel their development. Because of the homogeneous nature of commodities, the price is not set by the producer, making markets that are dependent on them vulnerable to global price fluctuations. When the price of oil plummeted in the midst of the financial crisis, for example, Russia suffered a significant drop in GDP.

Patrick Farrell, head of Advance Investment Solutions for BT Financial Group, says China has evolved beyond an agricultural economy and is now in an industrial phase. India has effectively leap-frogged the industrial phase, becoming a service-based economy, including a significant number of call-centre services to developed economies. He points out that while it would be complicated for countries that have outsourced their manufacturing centres to Asia to bring

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them back in-house, it's relatively easy to retract service contracts, leaving the Indian economy somewhat more vulnerable.

A further risk is in the protection of personal and intellectual rights. Developed markets tend to have more sophisticated checks and balances, while legal systems may not be enforced as rigorously in EMs. In some cases, EM systems are complex to negotiate and may even be compromised by corruption.

Political intervention can also dramatically affect the way an EM functions. EMs are often relatively unstable and governments can make sudden changes to rules and regulations, take actions to restrict foreign investment, or even nationalise corporations. An example of the effect of political intervention was the recent increase in tax on foreign investment by the Brazilian government. In another example, many Chinese companies are controlled by the state and there's no guarantee that shareholders' interests will be aligned with the government's interests.

Given the nature of EMs, before moving to the stage of selecting a product or a fund manager, planners should establish an investor's risk profile, age and time horizon. If an investor doesn't have the cash-flow, the time or the stomach to ride out short-term volatility, EMs are probably not the most appropriate investment vehicle. If EMs are a suitable investment, asking the right questions will help determine the right asset allocation for a particular individual's circumstances.

Farrell points out that many investors already have an exposure to EMs through their existing allocation to global multinational companies, which have growth exposure in those markets. In terms of asset allocation, he suggests a reasonable further allocation to direct investment in EMs might be around 10 per cent of the total international exposure to equities.

Alternatively, Urquhart suggests that a



Nader Naeimi

reasonable allocation to overseas equity markets would be around 25 per cent, with around one-third of that directly invested in EMs.

"You're not looking at where those markets are today, but where they're going to be in five to 10 years. If those markets are going to make up half of the global output and you only have a 10 per cent representation in your EMs exposure, that's clearly out of kilter.

"The simplest and safest way to invest is via a fund. Anyone considering directly investing in specific shares in an EM would need to be very careful."

Naeimi is far more aggressive in his recommendations for EM exposure, saying he personally has 80 per cent of his own superannuation equities allocation in EMs and only 20

'Anyone directly investing in specific shares in an EM would need to be very careful'

per cent in developed markets. He says even a more conservative investor should have around 50 per cent of their total portfolio in equities and around two-thirds of that in EMs.

"The risk is higher, but the fundamentals for EMs are much sounder than they were; where before we saw overvalued currency and budget deficits, we're now seeing the opposite with government savings and stable currencies."

It's Farrell's belief that India and China will dominate the scene for the next decade or two. Urquhart also lists those two markets as being amongst the EMs with the most potential growth going forward, in addition to Indonesia and Thailand.

"Indonesia has a lot of headroom and is becoming politically more stable. Incomes are growing, interest rates have dropped to single digits and inflation is now under control.

"While Thailand still has political risk, it has strong agricultural prices and auto exports. Ford has just made a half-a-billion-dollar manufacturing investment there, which is a big vote of confidence."

Farrell says sector-wise, technology and media look promising, while consumer goods and retail generally are likely to grow as wages in those countries continue to grow.

Naeimi agrees Asia represents the top pick

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EMERGING PERFORMERS

Fund Name	Net Assets \$m	Return 1 yr %	Return 3 yr %pa	Return 5 yr %pa	Return 10 yr %pa
Aberdeen Emerging Opportunities Fund	260.50	29.37	6.77	14.60	—
ANZ OA IP ING Gbl Emerg Mkts - EF/Sel	12.47	13.61	-6.63	7.83	—
ANZ OA IP ING Gbl Emerg Mkts - NE	25.01	12.64	-7.43	7.05	—
BNP Paribas Asset Management Emerg Markets Equity	3.45	12.31	-10.34	5.16	2.81
Colonial First State WS Global Emerging Markets	940.13	16.05	2.34	13.25	—
Dimensional Emerging Markets Trust	275.24	17.91	-1.95	10.87	—
GMO Emerging Markets Trust	440.69	12.54	-6.28	8.17	—
ING OA IP ING Gbl Emerg Mkts - EF/Sel	9.88	13.50	-6.55	7.86	—
ING OA IP ING Gbl Emerg Mkts - NE	8.00	12.57	-7.32	7.09	—
ING Wholesale-ING Global Emerging Markets	23.32	14.60	-5.78	8.72	—
ipac Strtgc Invest Srv - Global Emrg Mkts	3.55	15.77	-5.11	6.93	0.30
Lazard Emerging Markets Fund (I Class)	1,029.51	22.55	-0.36	14.23	9.90
Legg Mason Emerging Market Trust (Class A)	141.04	16.73	-2.90	9.37	7.28
Macquarie - Emerging Markets Share #	2.42	17.94	-2.18	11.55	7.05
Vanguard Emerging Markets Shares Index Fund	864.70	15.84	-0.99	11.63	6.06

Source: Morningstar Performance data to 31-May-10
Only funds with five year performance data are shown in the table

= closed to new investment

for growth going forward, followed by Latin America, due to its richness in commodities.

Farrell says while the trend is going towards specific country funds, he believes this approach is fraught with risk, adding that aggressive investment in any one region or sector could easily result in a bubble.

"Ideally, you need fund managers who can move funds about and have a diversified approach. Investors and planners should look for equity managers with EM capability, who understand the risks and have an exit strategy," he says.

Naeimi agrees on the potential for pricing bubbles, saying that while there's no evidence of one approaching any time soon, they are sure to come at some point.

"Wherever there's potential for a bubble, it's better to get in early. By the very nature of an EM fund, a good analyst can add so much more value than in a developed market fund," he says.

As an alternative to equities, Farrell says EM bonds look quite attractive and that yields will improve to a similar level as those of developed

markets over time.

"As EMs build up their credit ratings and manage inflation, confidence in those markets will also improve and bonds will become attractive for income. Bonds could be a good way to access EMs now, with the benefit of currency appreciation as those economies improve," he says.

Naeimi agrees the corporate bond sector could be interesting, suggesting there is likely to be a need for funds in the future. He recommends some allocation to Asia in particular, although adding that it's hard to get excited about EM bonds in the short term.

Urquhart agrees the fixed-income bond markets in EMs are somewhat underdeveloped currently.

"With the governments in surplus, there's not a large market for bonds," he says. "And with balance sheets strong, many companies don't need to issue them. There's an overall shortage of supply, and were they available, the yield would be lower in any case.

"The Asian crisis in particular taught those

countries a lot about debt, and the lessons of the past couple of years have just been a refresher course."

Farrell says exchange-traded funds (ETFs) are another option for investors and can supply a broad and cost-effective solution for diversification. All three commentators agree that an expert fund manager who understands the culture and the dynamics of what's happening domestically and overseas is a must.

"An expert is not necessarily going to just follow trends and is able to invest opportunistically," Farrell says.

"EMs will continue to develop, and with that will come opportunity for investors," he says.

"But critically, it's important to remain cognisant of risk and enlist advice from experts in those markets." ■

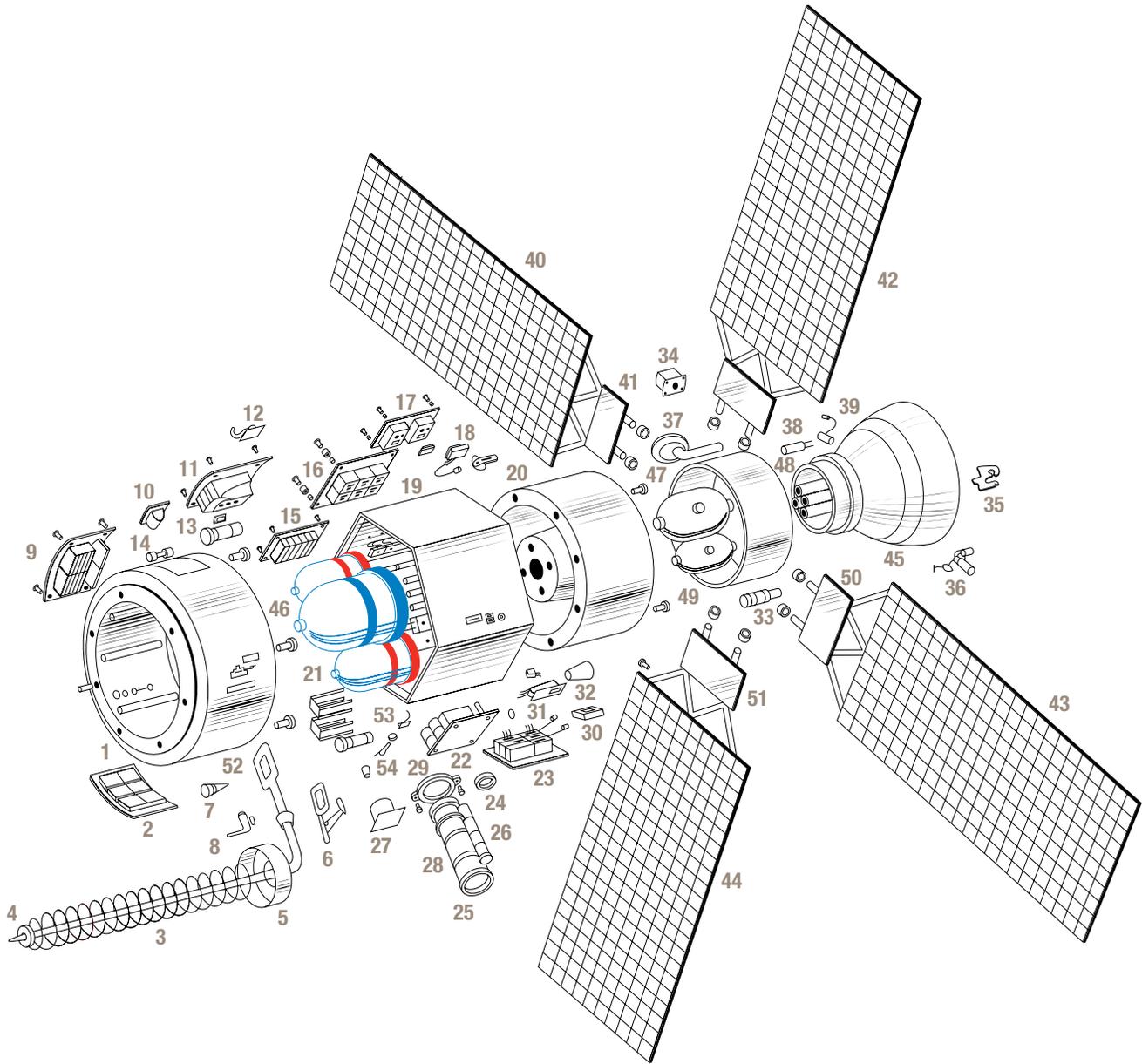
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